THE NEGATIVE IMPACT OF BASEL III ON SMALL BUSINESS FINANCING

SARAH PADGETT*

Many Americans feel strongly that deregulation was to blame for the financial collapse that occurred in 2008.[1] Nobel laureate Paul Krugman has echoed this view.[2] Krugman believes the financial crisis arose because "[r]egulation didn't keep up with the system," and "because of the ideological environment of the times, there was no attempt to expand regulation."[3] In the period leading up to the crisis, Krugman likened buying bank derivatives to "buying insurance for the Titanic from someone on the Titanic."[4]

In an effort to correct the problem, regulators across the globe have taken measures to strengthen the financial regulatory system.[5] Many of the new financial regulations have been targeted at banking institutions.[6] Basel III is a set of regulations that imposes more stringent standards for banks through measures aimed at increasing capital holdings, improving liquidity and preventing overleveraging.[7] While the Basel III requirements seek to effectuate financial stability, they cannot do so without generating some significant costs, many of which will be pushed on to consumers—particularly small businesses.[8]

---

* Juris Doctor, The Ohio State University Moritz College of Law, expected 2014.

1 *See* David Barker, *Is Deregulation to Blame for the Financial Crisis?*, THOMPSON REUTERS (July 7, 2012), http://newsandinsight.thomsonreuters.com/Legal/Insight/2012/07_-_July/Is_deregulation_to_blame_for_the_financial_crisis_/.

2 Rana Foroohar, *Keeping Economics Real*, NEWSWEEK (Oct. 17, 2008), http://www.thedailybeast.com/newsweek/2008/10/18/keeping-economics-real.html.

3 *Id.*

4 *Id.*

5 *Light Touch No More*, ECONOMIST (Dec. 1, 2012), http://www.economist.com/news/21567399-britains-financial-regulators-are-getting-much-tougher-light-touch-no-more.

6 *Id.*

7 Peter King & Heath Tarbert, *Basel III: An Overview*, BANKING & FIN. SERVS. POL'Y REP., May 2011, at 3–10.

8 Emmanouil Schizas, *Basel III and SMEs: Getting the Trade-off Right*, ACCT. FUTURES, Mar. 2012, at 3–4.

I. BACKGROUND: WHAT IS BASEL III?

Basel III is a set of regulatory reforms meant to address many of the issues associated with the recent financial crisis in the banking sector.[9] The first Basel Capital Accord was developed by the Basel Committee on Banking Supervision (BCBS) in 1988 to address concerns arising from deregulation in the financial sector.[10] Responding to the most recent banking crisis, the BCBS, whose membership is consists of banking and prudential regulators from over twenty-five countries,[11] has devised new regulations aimed at ensuring that banks will maintain financial stability during times of economic turmoil.[12] Basel III is the most recent installment of these Basel Accords and is meant to address many of the shortcomings of its predecessor, Basel II, which primarily addressed internal ratings, trade book and market risk and securitization.[13] Specifically, Basel III seeks to improve upon the quantity and quality of capital that banks have been required to hold under the Basel II framework by redefining core Tier I capital, restructuring bank liabilities and risk management and providing additional stability through capital buffer requirements.[14] Furthermore, while the prior Basel regulations focus exclusively on microprudential measures, Basel III also incorporates macroprudential standards into its regulatory framework to reduce systemic risk.[15]

---

[9] ORG. FOR ECON. CO-OPERATION & DEV., FINANCING SMES AND ENTREPRENEURS 2012: AN OECD SCOREBOARD 32 (2012).
[10] King & Tarbert, *supra* note 7, at 1.
[11] *Id.*
[12] ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9.
[13] RICARDO FABIANI, DUN & BRADSTREET, THE BUSINESS IMPACT OF 'BASEL III' 4 (2010).
[14] *See* King & Tarbert, *supra* note 7, at 3; Ranjit Lall, *Why Basel II Failed, and Why Any Basel III Is Doomed* 24 (Global Econ. Governance Programme, Working Paper No. 2009/52, 2009).
[15] King & Tarbert, *supra* note 7, at 3. Macroprudential regulation focuses on the health of the financial system as a whole, whereas microprudential regulation focuses on the stability of the financial system's component parts. *Macroprudential Analysis*, INVESTOPEDIA, http://www.investopedia.com/terms/m/macroprudential-analysis.asp#axzz2L03d6VgV (last visited Mar. 30, 2013); *Microprudential Regulation*, QFINANCE, http://www.qfinance.com/dictionary/microprudential-regulation (last visited Mar. 30, 2013).

II. REQUIREMENTS UNDER BASEL III

A. *Capitalization Requirements*

1. *Core Capital Requirements*

One of the most significant changes in Basel III is the introduction of a stringent definition of core Tier 1 capital. While Basel III maintains the basic capital standard of Basel I and II, which requires banks to retain total capital of approximately 8% of their risk-weighted assets (RWAs),[16] Basel III has imposed new limitations in terms of capital composition. Basel III requires that at least 75% of a bank's total capital consist of Tier 1 capital, while the remaining 25% may consist of Tier 2 capital.[17] Under Basel III, Tier 1 capital is "going-concern" capital consisting primarily of common equity—i.e. common stock, common stock surplus and retained earnings;[18] furthermore, common equity must make up at least 50% of a bank's total capital and at least 75% of a bank's Tier 1 capital.[19] The remaining Tier 1 capital may consist of preferred stock or other forms of paid-in capital that fall outside the common equity classification. In contrast to core Tier 1 capital, Tier 2 is "gone-concern" capital, because although it provides some additional capital cushion, it will quickly be absorbed by a bank as it approaches insolvency; Tier 2 capital primarily consists of lower forms of equity and junior liability.[20] Under Basel III, these core capital requirements are scheduled to be phased in starting in 2013, with complete implementation by 2015.[21]

2. *Valuation of Risk-Weighted Assets*

RWA values are fundamental to Basel III's capital requirements and can be determined by assessing Counterparty Credit Risks (CCRs).[22] RWA values can be determined by one of two methods: the standardized method or the Internal Ratings-Based approach (IRB).[23] The standardized method is the default method used by the majority of banks, which assesses CCRs through use of external credit ratings: banks determine the value of RWAs first by determining the specific class of asset (e.g., retail, sovereign

---

[16] King & Tarbert, *supra* note 7, at 3.
[17] *Id.*
[18] *Id.* at 4.
[19] *Id.* at 3.
[20] *Id.* at 4.
[21] BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 28 & annex 4 (2011).
[22] King & Tarbert, *supra* note 7, at 7.
[23] ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9, at 33.

government), then by looking to the credit rating ascribed to the counterparty by an external credit assessment institution.[24] Large, sophisticated banking institutions may elect to use the IRB, which uses internal risk models to determine the capital needed to offset the RWAs, based upon the bank's estimates of the probability of loan default and exposure to loss.[25]

3. *Ratio of Tier 1 Capital to Risk-Weighted Assets*

Under the Basel III standards, banks are required to maintain a minimum ratio of 4.5% Tier 1 common equity to RWAs.[26] In conjunction with the 4.5% common equity minimum, Basel III also requires that banks maintain a capital conservation buffer in the way of an additional 2.5% of Tier 1 capital, in order to further ensure stability in times of economic duress.[27] Effectively, the Tier 1 common equity ratio and capital conservation buffer will require banks to maintain a total ratio of 7% Tier 1 capital to RWAs at any given time.[28] In times of exigency, banks may dip below 7%, but will be expected to replenish the capital buffer to remain in compliance.[29]

4. *Additional Capital Requirements*

Together with Basel III's microprudential capital requirements, standards such as the countercyclical capital buffer aim to achieve the macroprudential goal of protecting the banking sector during times of widespread credit growth.[30] The countercyclical capital buffer is a measure which countries may choose to impose during times of excessive credit growth and will require additional Tier 1 holdings ranging from 0% to 2.5% of RWA.[31]

Another macroprudential measure put forth by Basel III is a surcharge on Global Systemically Important Financial Institutions (GSIFIs). For certain GSIFIs, a further 1% to 2.5% of Tier 1 capital could be required depending on the bank's size, global activity and the availability of competition.[32] In total, these measures would require all banks to hold 7% Tier 1 capital and to hold up to 9.5% during times of heightened risk, with

---

[24] *Id.*
[25] *Id.*
[26] King & Tarbert, *supra* note 7, at 5.
[27] *Id.*
[28] *See id.*
[29] *Id.*
[30] ACCENTURE, BASEL III HANDBOOK 25 (2012).
[31] *Id.*
[32] ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9, at 33.

capital requirements possibly reaching as high as 12% for GSIFIs.[33] The countercyclical buffer and GSIFI surcharge would be phased in later than the core capital requirements, between 2016 and 2018.[34]

B. *Leverage Ratio*

In addition to the risk-based capital requirements, Basel III has introduced a non-risk-based leverage ratio designed to supplement the capitalization standards by providing a check for efficacy of capital adequacy measurements.[35] At this stage, use of the leverage ratio is largely at the discretion of financial regulators, with reporting requirements beginning in January of 2013 and the ratio ultimately becoming binding by 2018.[36] A leverage ratio of at least 3% is suggested, which will be calculated by dividing a bank's Tier 1 capital measurement by its percentage of total exposure (including both balance sheet and off-balance sheet items).[37]

C. *Liquidity Requirements*

Illiquidity was another significant problem encountered during the recent crisis in the banking sector; many banks found that they could not quickly turn their assets into cash and instead had to rely on central bank lending facilities to resolve issues with short-term lending.[38] Basel III has developed liquidity requirements—a liquidity coverage ratio and net stable funding ratio—to ensure that banks maintain a sufficient level of unencumbered liquid assets at any given time.[39] The liquidity coverage ratio (LCR) requires a bank to maintain high-quality liquid assets that are equal to or greater than its net total cash outflows for the next thirty-day period.[40] Net cash outflows are defined as expected cash outflows minus total expected cash inflows, up to a cap of 75% of expected outflows; in other words, banks would always be required to maintain at least 25% of their expected cash outflows as liquid assets at any given time.[41] The LCR is scheduled to take effect beginning in 2015, with banks being required to meet 60% of the LCR obligations at this point, and it will become fully

---

[33] *Id.* at 33 tbl.3.1.
[34] BASEL COMM. ON BANKING SUPERVISION, *supra* note 21, at annex 4.
[35] ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9, at 34.
[36] *Id.*; BASEL COMM. ON BANKING SUPERVISION, *supra* note 21, at annex 4.
[37] ACCENTURE, *supra* note 30, at 32.
[38] King & Tarbert, *supra* note 7, at 9.
[39] ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9, at 34.
[40] King & Tarbert, *supra* note 7, at 9.
[41] *Id.*

phased in by 2019.[42] This timeline represents a significant departure from the original plan, which envisioned mandatory applicability of the LCR in 2015.[43]

Like the LCR, the net stable funding ratio (NSFR) is another Basel III mechanism designed to ensure a bank maintains adequate liquidity.[44] Whereas the LCR deals with short-term liquidity (thirty days), the NSFR is designed to ensure a bank has sufficient longer-term liquidity (one year).[45] The NSFR is determined by comparing the available amount of stable funding over the required amount of stable funding for a one-year period.[46] The available amount of stable funding must equal at least 100% of the required amount of stable funding.[47] The NSFR, like the LCR, will begin with an observation period[48] but will not become mandatory until 2018.[49]

III. ECONOMIC IMPACT UNDER BASEL III

If Basel III is ultimately successful in achieving its purpose, businesses may profit in the long-term on account of the economic stability the new standards will provide.[50] Some proponents of the new regulations have argued that this stability will prove particularly beneficial to small businesses, which are more affected during times of economic crisis than larger, more established companies.[51] However, many critics are skeptical that the Basel III reforms will actually harm—rather than benefit—businesses by causing a significant reduction in lending to small and medium-sized enterprises (SMEs) and new business enterprises.[52]

A. *Greater Impact on Smaller Lending Institutions*

The new Basel III capital requirements may prove especially problematic for smaller financial institutions, such as community banks and

[42] Jim Brunsden, Giles Broom & Ben Moshinsky, *Banks Win 4-Year Delay as Bank Liquidity Rule Loosened*, BUSINESSWEEK (Jan. 7, 2013), http://www.businessweek.com/news/2013-01-06/banks-win-watered-down-liquidity-rule-after-basel-group-deal.
[43] BASEL COMM. ON BANKING SUPERVISION, *supra* note 21, at annex 4.
[44] King & Tarbert, *supra* note 7, at 9.
[45] *Id.* at 10.
[46] *Id.*
[47] *Id.*
[48] *Id.* at app. D.
[49] *Id.*
[50] ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9, at 34–35.
[51] *Id.*
[52] *Id.* at 35.

credit unions.[53] Smaller regional banks will be uniquely impacted by Basel III for a variety of reasons. First, low interest rates and high unemployment have had a disproportionately negative impact on small banks,[54] and the Basel III standards will exacerbate this financial stress. Second, the RWA model will have greater impact on regional banks because retail customers and SMEs represent a large portion of their customer base.[55] Furthermore, small banks, with access to fewer resources, will have difficulties raising the additional amounts of capital necessary to offset the risk of lending to small businesses.[56] As many small businesses and startups rely on loans from local banks,[57] the effect may be that these companies are never able to get up and running.

Community banks have already faced capital issues that have curbed small business lending.[58] Recognizing the negative effects of this undercapitalization, the U.S. Department of the Treasury has already paid out over four billion dollars to community banks through the Small Business Lending Fund (established as part of the Small Business Jobs Act of 2010).[59] The Basel III requirements may further exacerbate the undercapitalization of smaller lending institutions, making SME financing even more challenging. Demonstrating the difficulties that the new standards pose for community banks, in September 2012 the business loan approval rating for credit unions dropped for the fourth consecutive month to its lowest rate since June 2011.[60] Similarly, the number of loans approved by small banks also dropped.[61]

Many community bank coalitions, such as the Independent Community Bankers of America (ICBA), have expressed intense disapproval of the Basel III reforms and have petitioned for modification of the standards as

---

53 Shea Dittrich, *How Basel III Capital Requirements Hurt Community Banks*, AM. BANKER (Sept. 26, 2012), http://www.americanbanker.com/bankthink/how-basel-iii-capital-requirements-hurt-community-banks-1053011-1.html.
54 Alex Bryan, *Regional Banks: Small Enough to Succeed*, SEEKING ALPHA (Dec. 21, 2012), http://seekingalpha.com/article/1080831-regional-banks-small-enough-to-succeed?source=bloomberg.
55 *Id.*
56 Howard Schneider, *Capital Trouble*, INDEP. BANKER, Oct. 2012, at 23, 24–26.
57 ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9, at 39 (emphasizing SME reliance on financing from small local banks).
58 *See generally Small Business Lending Fund*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/resource-center/sb-programs/Pages/Small-Business-Lending-Fund.aspx (last visited Mar. 30, 2013).
59 *Id.*
60 Michelle A. Samaad, *Alternative Lenders Continue to Beat Credit Unions, Banks in Business Loan Approvals*, CREDIT UNION TIMES (Oct. 10, 2012), http://www.cutimes.com/2012/10/10/alternative-lenders-continue-to-beat-credit-unions?ref=hp.
61 *Id.*

applied to community banks.[62] In addition to highlighting the greater burdens these regulations will pose to community banks, the ICBA has pointed to issues of fairness with the new regulations.[63] Namely, the ICBA has pointed to the fact that large, systemically important banks were the major culprits behind the financial crisis and that community banks did not engage in the sort of reckless lending practices that led to the economic downturn.[64]

Other commentators are less sympathetic to the plight of community banks and are pushing for the adoption of more uniform regulations.[65] Experts in the United Kingdom have noted that creating separate rules for large banks would be problematic because it would increase the risk of "accidental arbitrage."[66] Although the general sentiment within the United States has been that community banks should be subject to different regulatory requirements than their larger counterparts, most commentators feel that increased capital standards are necessary to some extent.[67] Commentators who are particularly opposed to exemptions for community banks note that in the period leading up to the financial crisis, many community banks went overboard with their lending practices.[68] These critics cite this imprudent lending as the ultimate cause for the failure of several of these institutions and their subsequent indebtedness to the Treasury Department under the Troubled Asset Relief Program (TARP).[69]

B. *Small and New Businesses Will Be Assigned High Risk Weights*

The new regulations will not only disproportionately affect community banks, but also they will disproportionately impact SMEs and startup companies. Small businesses and individuals will be ascribed a retail risk rating of 75%, provided the bank's retail portfolio is diverse and no loan exceeds one million Euros.[70] However, if the bank does not meet these

---

[62] *Community Bank Petition to the Federal Reserve, OCC, and the FDIC*, INDEP. CMTY. BANKERS OF AM., http://www.icba.org/BaselIIIPetition/petition.cfm (last visited Mar. 30, 2013).
[63] *Id.*
[64] *Id.*
[65] Richard Crump, *Separate Rules for Banks a "Mistake," Lawson Told*, ACCT. AGE (Jan. 24, 2013), http://www.accountancyage.com/aa/analysis/2238754/separate-rules-for-banks-a-mistake-lawson-told; Vincent Ryan, *Man Up, Community Bankers*, CFO.COM (Nov. 9, 2012), http://www3.cfo.com/blogs/banking-cap-markets/banking--capital-markets/2012/11/Man-Up-Community-Bankers.
[66] Crump, *supra* note 65.
[67] Ryan, *supra* note 65.
[68] *Id.*
[69] *Id.*
[70] ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9, at 36.

conditions, an SME loan will be assigned a risk weight of 100%.[71] In contrast, loans to sovereign governments and central banks with a high credit rating would have a risk weight of 0%,[72] and large companies with a high credit rating would have a risk weight of only 20%.[73] These risk weight differentials would have a huge impact in terms of capital requirements needed to offset loans to small businesses. While financing an SME could require the bank to hold up to 7% of the loan amount as capital (100% risk weight multiplied by 7% capital), a loan to a large company may require only 1.4% (20% risk weight multiplied by 7% capital). Thus, a \$100,000 loan could be made to a large company with an AAA to AA- credit rating—with \$1400 in capital needed to offset the loan—or to a sovereign government—requiring no offsetting capital—whereas a loan in this amount to an SME would require the bank to hold \$5250 (for SMEs with a 75% risk weight) or \$7000 (for SMEs with a 100% risk weight) in capital.[74]

C. *Adverse Economic Impact*

1. *Generally*

While Basel III is designed to promote long-term global economic stability, the immediate impact will likely be to stunt economic growth.[75] The Institute of International Finance (IIF) published a report addressing the impact financial regulatory changes like Basel III will have upon the global economy.[76] The IIF report found that some measure of financial regulatory reform was necessary to ensure long-term stability in the financial sector.[77] However, the IIF concluded that the current measures, like Basel III, may not facilitate these ends.[78] Generally, the IIF report concluded that the current global economy is ill-equipped to handle the new regulations and that in the short-term, these changes would place even heavier burdens on an already faltering economy, prohibiting growth.[79] Furthermore, the IIF report estimated that in the United States, Europe,

---

[71] *Id.*
[72] *Id.*
[73] *Id.* at 37.
[74] *See id.* at 33–37.
[75] Brooke Masters, *FSA Eases Bank Rules to Boost Lending*, FIN. TIMES (Oct. 10, 2012), http://www.cnbc.com/id/49353389/.
[76] *See generally* INST. OF INT'L FIN., THE CUMULATIVE IMPACT ON THE GLOBAL ECONOMY OF CHANGES IN THE FINANCIAL REGULATORY FRAMEWORK (Sept. 2011).
[77] *Id.* at ii.
[78] *Id.*
[79] *Id.*

Japan and Switzerland there could be a realized loss of up to 3.2% of GDP over the next five years, attributable to the new financial regulations.[80]

The IIF report found that the new regulatory reforms would reduce overall economic activity in two ways: first, by raising the cost of extending credit, and second, by reducing the overall availability of credit.[81] The transactional cost of the regulatory reforms will be passed through to borrowers in the form of higher interest rates.[82] Furthermore, in order to comply with the new regulations, banks will change their business models in ways which are not profit maximizing, reducing retention of higher-risk assets in favor of low-yielding claims.[83] In support of this conclusion, the IIF found that, thus far, banks that have had difficulties meeting capital requirements have declined to lend to risky borrowers, such as SMEs, and have extended less credit in general.[84] In addition, banks may find that the simplest way to comply with the liquidity requirements is by reducing loans.[85]

The International Monetary Fund (IMF) published a report criticizing the IIF findings for their short-term focus and failure to take into account other cost-reducing measures that banks might employ to lessen economic harm.[86] Although the IMF report concluded that the new regulations would produce long-term benefits in terms of market stability, the report acknowledged that the regulations would also generate significant costs, which it likened to "insurance premiums."[87] The IMF found that there would not be a 100% pass-through to third party borrowers in terms of credit pricing and availability and that the regulations would cause some increase in the costs of obtaining credit and some decrease in credit availability.[88] Furthermore, many of the other methods the IMF report pointed to in relation to banks' cost mitigation strategies could have issues of feasibility or raise other economic concerns. Examples of these cost mitigation strategies include reducing expenses, restructuring the business, absorbing costs by lowering returns to shareholders and meeting the requirements through technicalities.[89] Even with the use of cost mitigation

---

[80] *Id.*
[81] *Id.* at 38.
[82] INST. OF INT'L FIN., *supra* note 76, at 38.
[83] *Id.*
[84] *Id.* at 33.
[85] *Id.* at 40.
[86] ANDRÉ OLIVEIRA SANTOS & DOUGLAS ELLIOTT, INT'L MONETARY FUND, ESTIMATING THE COSTS OF FINANCIAL REGULATION 6 (2012).
[87] *Id.* at 4.
[88] *Id.* at 8.
[89] *Id.* at 8–9.

strategies, the bottom line is that Basel III will increase costs for banks and these costs will be passed on to borrowers.[90]

Other commentators have also pointed to the economic shortcomings of the Basel III reforms.[91] Although the Basel III capital requirements and risk management standards aim to prevent future bank failures, their effect may be to further weaken the financial sector.[92] First, the new standards will result in smaller, weaker banks being forced out of the market by larger banks that are better able to comply with the standards.[93] Second, the regulations will place further pressure on bank operations and profitability.[94] Finally, the regulations will reduce banks' lending capacity.[95] These burdens will be reflected upon the economy as a whole, which will suffer because of decreased consumer credit availability and diminished monetary flow resulting from banks' capital retention.[96]

2. *Adverse Impact on Small Business*

Small businesses in particular will bear the brunt of the economic consequences in the form of higher lending rates and decreased credit availability.[97] Because SMEs will have high risk weights—requiring greater amounts of capital—banks will be forced to cut down on the amount of lending they extend to these recipients.[98] This decreased SME lending is problematic for a variety of reasons. First, there is a fairness consideration: SMEs were not the cause of the recent financial crisis; however, SMEs were the businesses hit the hardest.[99] Decreased credit availability will impose greater burdens on small businesses that are already struggling financially. A second consideration involves the role of SMEs in terms of the overall economy. Globally, SMEs account for approximately 50% of all private sector output and 63% of private sector employment.[100] If many of these SMEs are unable to secure financing because of the new regulations, the result will be diminished output and employment globally. Finally, while some concessions in terms of small business growth may be

---

[90] *Id.* at 4.
[91] Shawn Baldwin, *Basel Barriers: How Capital Requirement Would Impede Progress in the Sovereign Debt Crisis*, FORBES (Oct. 15, 2012), http://www.forbes.com/sites/shawnbaldwin/2012/10/15/basel-barriers/.
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] *Id.*
[97] Schizas, *supra* note 8.
[98] *Id.* at 4.
[99] ASS'N OF CHARTERED CERTIFIED ACCTS., *Framing the Debate: Basel III and SMEs*, ACCT. FUTURES, July 2011, at 3.
[100] *Id.* at 5.

defensible to yield greater market stability, the capital requirements are not sufficiently narrowly tailored to further this goal.[101]

Banks' responses to the regulations thus far have bolstered this theory. Rather than raising additional capital, many banks have chosen to maintain capital close to pre-Basel III levels, instead of reducing RWAs.[102] In particular, banks have cut back on "riskier" lending, such as loans to small businesses.[103] Furthermore, some lenders intend to comply with the new regulations by shedding all business loans other than loans to their core business customers.[104] While SME lending has declined because of the risk weight system, the risk rating ascribed to these assets under Basel III's framework may be a poor reflection of actual risks associated with the loans.[105] Hence, regulatory compliance will be at the detriment of many SMEs and will not necessarily be a benefit in terms of risk mitigation and market stability.[106]

The United Kingdom has already experienced negative economic consequences as a result of implementing the Basel III regulations.[107] Specifically, U.K. regulators have found that overly aggressive implementation of the new standards has caused corporate lending to decline.[108] As part of a concentrated effort to promote increased business lending, the Financial Services Authority has relaxed the capital, leveraging and liquidity requirements for U.K. banks.[109] Similar to the situation in the United Kingdom, there is a real possibility that implementation of the new standards in the United States could lead to a double-dip recession[110] if companies are unable to secure necessary funding.[111]

Similarly, European Union lawmakers have found it necessary to lower the capital buffer requirements in regards to small business lending by reducing SME risk weighting down to 30%.[112] This is because, in spite of

---

[101] Schizas, *supra* note 8, at 3–5.
[102] *Id.* at 8.
[103] *Id.*
[104] *Both FinMin and RBI Want Banks to Shed Their Non-Core Business*, ECON. TIMES (Dec. 26, 2012), http://articles.economictimes.indiatimes.com/2012-12-26/news/36008176_1_sector-banks-basel-iii-psbs.
[105] Schizas, *supra* note 8, at 8.
[106] *Id.*
[107] *See* Masters, *supra* note 75.
[108] *See id.*
[109] *Id.*
[110] The term "double-dip recession" refers to a recession, followed by a short-lived recovery, followed by another recession.
[111] Masters, *supra* note 75.
[112] Claire Davenport, *EU Lawmakers Agree on Softer Capital Buffers for SME Loans*, FOX BUS. (Oct. 5, 2012), http://www.foxbusiness.com/news/2012/10/05/eu-lawmakers-agree-on-softer-capital-buffers-for-sme-loans/.

SMEs' central importance in the European economy, small business lending has declined by 20% since the European Union began implementing the Basel regulations.[113] Furthermore, during this time frame SMEs have also been subject to higher interests rates and shorter maturities than larger, well-established companies.[114] Ensuring the success of these SMEs is important to achieving a healthy economy, as SMEs contribute significantly to innovation, job creation and social stability.[115]

Another significant problem will be increased competition among SMEs and startup businesses vying for lending as a result of decreased credit availability.[116] Small local businesses will be assigned the same risk weights as high-potential startups.[117] The result may be that local "mom and pops," who can expect only modest financial returns, will be squeezed out by startups with high profit potential.[118]

The impact of Basel III in the European Union demonstrates that in addition to decreased small business lending, the transactional costs of the new regulations will also be pushed on to small businesses and other enterprises with relatively higher risk weights.[119] Rather than bear the cost of the regulations themselves, banks will impose additional costs on borrowers. Business consumers will face higher interest rates on loans in addition to more fees.[120]

3. *U.S. Regulators' Differing Opinions on Implementation*

While the situation in the European Union and United Kingdom has demonstrated the threat the Basel III regulations pose to small businesses,[121] some U.S. officials are pushing for rapid implementation of the new reforms, in addition to even stricter regulations than required under Basel III.[122] The Systemic Risk Council, led by former FDIC Chairman Sheila Bair, is urging that U.S. regulators implement the Basel III regulations more

---

[113] *Id.*

[114] *Id.*

[115] Andrew Sheng, *Shadow Banking . . . or Ghosts in the Machine?*, STAR ONLINE (Dec. 22, 2012), http://biz.thestar.com.my/news/story.asp?file=/2012/12/22/business/12483115&sec=business.

[116] Aaron Chatterji, *Why Washington Has It Wrong on Small Business*, WALL ST. J. (Nov. 12, 2012), http://online.wsj.com.

[117] *See* ORG. FOR ECON. CO-OPERATION AND DEV., *supra* note 9, at 33.

[118] Chatterji, *supra* note 116.

[119] *See* Davenport, *supra* note 112.

[120] Victor Nava, *Basel III Hurts Community Banks and Consumers*, REAL CLEAR MARKETS (Nov. 1, 2012), http://www.realclearmarkets.com/articles/2012/11/01/basel_iii_hurts_community_banks_and_consumers_99966.html.

[121] Davenport, *supra* note 112; Masters, *supra* note 75.

[122] Shahien Nasiripour & Tom Braithwaite, *U.S. Regulators Urged to Outdo Basel III Rules*, FIN. TIMES (Oct. 4, 2012), http://www.ft.com.

rapidly than would otherwise be required under the Basel timeframe.[123] Additionally, the Systemic Risk Council is advocating stricter leveraging requirements, "which would limit banks' assets to 12 times their capital, rather than 33 times their capital," as required under Basel III.[124]

Should the Systemic Risk Council's suggestions be adopted, they may provide additional safeguards in terms of bank stability, but they will inevitably place greater burdens on small businesses and startup companies that are unable to obtain bank credit, or who find the financing options overly cost prohibitive.[125] Other individuals, such as FDIC Director Thomas Hoenig, are less optimistic that the Basel III regulations can effectively resolve the issues in the banking sector.[126] Hoenig feels that the Basel regulations are overly complex and that the capital requirements are not well-tailored to solving the problems in the banking sector that emerged during the financial crisis.[127] Instead, Hoenig believes long-term stability in the financial sector could be better achieved using a straight-forward method: one which looks at the ratio of tangible equity to tangible assets and emphasizes the importance of supervisory oversight to ensure compliance.[128]

D. *Mitigating the Burdens of Regulatory Compliance*

One possible solution for banks may be to secure SME loans with government-backed guarantees.[129] Since governments with AAA credit ratings have risk weights of zero, a government guarantee would eliminate the risk associated with the guaranteed portion of the SME loan, thereby reducing the bank's overall capital requirement.[130] However, this approach would only work in situations where the government was willing to guarantee these small business loans and had a good credit rating. While government-backed loans would necessitate the least amount of capital, it may also be possible to have SME loans backed by other, less-risky

---

[123] Rick Rothacker, *Council Urges Tighter Capital Standards for U.S. Banks*, REUTERS (Oct. 5, 2012), http://www.reuters.com/article/2012/10/05/bank-regulations-idUSL1E8L51DS20121005.
[124] *Id.*
[125] Douglas J. Elliott, Basel III, The Banks, and the Economy 1 (July 23, 2010) (unpublished research paper, Brookings Inst.), http://www.brookings.edu/research/papers/2010/07/26-basel-elliott.
[126] Thomas M. Hoenig, Dir., Fed. Deposit Ins. Corp., Testimony at the American Banker Regulatory Symposium in Washington, D.C.: Back to Basics: A Better Alternative to Basel Capital Rules (Sept. 14, 2012).
[127] *Id.*
[128] *Id.*
[129] ORG. FOR ECON. CO-OPERATION AND DEV., *supra* note 9, at 36.
[130] *Id.*

guarantors,[131] such as larger companies. While this would not eliminate the need for capital, it may reduce capital requirements to a level that would no longer disincentivize lending to small businesses. Furthermore, other forms of collateral could be used for similar risk mitigating effects; for example, a business owner may give the bank a security interest in his or her residential property.[132]

1. *Regulatory Arbitrage*

On an international level, the Basel III standards will have a disparate impact, with varying costs of implementation and profitability across the board.[133] For some states, the costs of implementation, supervisory oversight and decreased competitiveness may outweigh the benefits.[134] Hence, while Basel III is largely designed as a mandatory, rather than discretionary set of standards,[135] those countries that are burdened the most by the new regulations will be the most reluctant—and the slowest—to implement them.[136] Because there will inevitably be variation in the rate and method in which different countries choose to adopt the Basel III regulations, banks may engage in regulatory arbitrage to get around these standards.[137] Supporting banks' ability to engage in arbitrage is the fact that many countries (e.g., Sweden, Switzerland, the United Kingdom, Austria and the United States) have experienced a push from regulators to impose more stringent requirements than those submitted under Basel III, whereas in other countries (e.g., New Zealand) regulators have said they do not intend to implement many of the new standards.[138]

Under the Basel III standards, the ability to engage in regulatory arbitrage is particularly feasible because the risk-weight system does not reflect the actual risk a bank incurs in extending loans or credit.[139] Because

---

[131] *Id.*
[132] *Id.*
[133] Narissa Lyngen, Recent Development, *Basel III: Dynamics of State Interpretation*, 53 HARV. INT'L L.J. 519, 522 (2012).
[134] *See id.* ("Variations among states' domestic regulated sectors mean . . . distinct costs of implementation for each state and implications for the international competitiveness and profitability of that state's regulated sector . . . . [S]ome states will enjoy more of the benefits of a global regulatory standard, while others will face a disproportionate amount of the costs.").
[135] *Id.* at 528–29.
[136] *Id.* at 522.
[137] FABIANI, *supra* note 13, at 6.
[138] Lyngen, *supra* note 133, at 520; Nasiripour & Braithwaite, *supra* note 122.
[139] Takeo Hoshi, *Implementation of Basel III in the US will Bring Back the Regulatory Arbitrage Problems Under Basel I*, VOXEU.ORG (Dec. 23, 2012), http://www.voxeu.org/article/implementation-basel-iii-us-will-bring-back-regulatory-arbitrage-problems-under-basel-i.

of this, banks will have an incentive to take on loans whose actual risk is higher than the risk weight ascribed under the Basel III standards.[140] For example, a thirty-year amortizing mortgage with a loan-to-value ratio of 60% to 80% will be ascribed a risk weight of 50%, while an interest-only loan with the same loan-to-value ratio will be ascribed a risk weight of 100%.[141] If the actual risk of the interest-only loan is less than twice the risk of the thirty-year amortizing loan, a bank will approve the riskier, thirty-year amortizing loan rather than the interest-only loan.[142] This sort of regulatory arbitrage will allow banks to increase profit potential without a corresponding increase in capital holdings.[143] Engaging in such behavior is problematic, however. It will, to some extent, render Basel III's risk-mitigation goals ineffective.

Further enabling banks to engage in regulatory arbitrage is the lack of a uniform risk-calculation system across the board.[144] Stefân Ingves, Chairman of the BCBS, has noted that since the implementation of Basel III, there has been "material variation" across the industry in the way that banks calculate the risk of their assets.[145] Ingves has proposed that this wide variation could be remedied through "tougher disclosure rules or limitations in the [risk-modeling] choices for banks."[146] In the meantime, significant divergences in bank compliance continue.[147] U.S. bankers, including the CEO of JPMorgan Chase, have noted that the "flexible implementation of previous rounds of Basel capital rules . . . has allowed European lenders to hold less capital" than U.S. banks.[148] Additionally, banks in both the United Kingdom and United States have fallen short of meeting the January 2013 deadline for implementing many of the new regulations.[149] Until regulators find a way to rectify these disparities, there will continue to be a strong incentive for regulatory arbitrage.[150]

Many lending institutions have begun fashioning innovative methods to eschew the liquidity requirements.[151] JPMorgan Chase has developed a system to avoid the liquidity issues by converting variable rate demand

[140] *Id.*
[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] *See* Ben Moshinsky, *Banks May Face Limits on Risk Calculations, Basel Chief Says*, BLOOMBERG (Jan. 24, 2013), http://washpost.bloomberg.com.
[145] *Id.*
[146] *Id.*
[147] *Id.*
[148] *Id.*
[149] *Id.*
[150] *See* Moshinsky, *supra* note 144.
[151] Coby Kutcher & Thomas Jacobs, *Innovative Liquidity Structure Is Credit Positive for Variable Rate Demand Debt Issuers*, MOODY'S CREDIT OUTLOOK, Sept. 24, 2012, at 20.

bonds (VRDBs) into callable commercial paper with a variable length of maturity of no less than thirty-one days.[152] At least thirty-one days prior to the date of maturity, the issuer would call the paper.[153] Because this call option is exercised outside the thirty-day window, it in effect creates an exemption from inclusion in the LCR calculation.[154] If companies such as JPMorgan Chase are able to successfully employ these methods, it may help banks meet the new liquidity requirements, in turn creating greater credit availability for businesses.[155]

In addition to their VRDB conversion technique, JPMorgan Chase has fashioned a similar callable commercial product, aimed at allowing municipal users to achieve floating rates.[156] Using this product, JPMorgan Chase acted as a remarketing agent together with Morgan Stanley, allowing the Sunshine State Governmental Financing Commission to issue $115 million in debt to the city of Orlando.[157] This callable commercial product works similarly to the convertible VRDBs (falling outside the applicable thirty-day window), but whereas the predecessors to this deal have had maturities of 60–90 days, the municipal deal had a maturity of 136 days.[158] If companies such as JPMorgan Chase and Morgan Stanley continue to successfully employ these methods, it may not only help municipal customers, but could also ease the financial burdens on SME borrowers.[159]

Front-loading is another practice many banks have adopted in order to avoid the new regulations.[160] Front-loading involves issuing large amounts of debt instruments just prior to the switch-over to the new capital standards at the beginning of 2013.[161] Since Basel III adopts a stricter definition of Tier 1 and Tier 2 capital, issuing debt just prior to the date in which the new standards became binding (January 1, 2013) prevented the exclusion of these debt instruments from a bank's capital holdings.[162] Canadian lenders such as the Royal Bank of Canada and Canadian Imperial Bank of

---

152 Robert Slavin, *Moody's: New Liquidity Structure Is Good for Variable-Rate Issuers*, BOND BUYER (Oct. 2, 2012), http://www.bondbuyer.com/issues/121_191/moodys-says-new-commercial-paper-could-provide-liquidity-solution-variable-1044566-1.html.
153 *Id.*
154 Kutcher & Jacobs, *supra* note 151.
155 Slavin, *supra* note 152.
156 Tonya Chin, *Morgan Stanley Joins JPM in Offering New Product*, BOND BUYER (Jan. 23, 2013), http://www.bondbuyer.com/issues/122_16/jpmorgan-new-callable-commercial-product-gaining-interest-muni-community-1047959-1.html.
157 *Id.*
158 *Id.*
159 Slavin, *supra* note 152.
160 Katia Dmitrieva, *Front Running Basel III Spurs Record Bank Offers*, CAN. CREDIT (Dec. 24, 2012).
161 *Id.*
162 *Id.*

Commerce have adopted the front-loading method by issuing a high number of domestic bonds.[163] In December 2012, Canadian banks issued $4.6 billion CAD in domestic bonds, which was more than double the amount issued in December 2011.[164] Similarly, there has been a rush among Chinese banks to sell subordinated debts prior to the January 1 effective date for the new capital standards.[165]

There will inevitably be opportunities for regulatory arbitrage under Basel III because of differential rates and methods of implementation, and other factors such as the inability of the RWA model to perfectly reflect actual risks.[166] This regulatory arbitrage is problematic because banks may be able to comply with the letter of the law without complying with the spirit of the law—that is, by failing to actually mitigate risk. Furthermore, regulatory arbitrage may result in private benefits for banks and borrowers, at a cost to society as a whole in the form of decreased economic stability.[167] However, the "optimal amount of regulatory arbitrage is not zero," and regulatory arbitrage may be beneficial to the extent that it benefits social welfare.[168] Specifically, regulatory arbitrage may be advantageous to the extent that it fosters economic growth (or at least, minimizes economic harm) by increasing credit availability among SMEs and by reducing transaction costs. However, the optimal level of regulatory arbitrage must be small enough to yield a significant decrease in overall risk, so as to prevent banks from being put back into the sort of precarious financial position that led to the recent crisis in the banking sector, which prompted the adoption of Basel III.

E. *Alternative Financing for Small Businesses*

While banks are likely to develop some measures making it possible to extend credit to SMEs, it is inevitable that Basel III will, to some extent, decrease overall credit availability for small businesses.[169] Given the added burdens associated with obtaining bank financing, an increasing number of small businesses have been looking to alternative sources of funding.[170] Alternative funding may be a particularly feasible solution in the United States, because of the availability of alternative debt intermediation sources.[171] Since Basel III was passed, many of these alternative lending

---

163 *Id.*
164 *Id.*
165 Wang Jiamei, *Banks Dash to Place Junior Debt*, GLOBAL TIMES (Dec. 24, 2012), http://www.globaltimes.cn/content/752000.shtml.
166 *See* Lyngen, *supra* note 133; Hoshi, *supra* note 139.
167 Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 234 (2010).
168 *Id.*
169 FABIANI, *supra* note 13, at 2.
170 Samaad, *supra* note 60.
171 INST. OF INT'L FIN., *supra* note 76, at 36.

sources, such as micro-lenders, accounts receivable financers, merchant cash advance lenders and community development financial institutions, have experienced a surge in demand from SMEs.[172] Small business owners have found some of these alternative lending sources particularly desirable because of the greater loan approval rating and more flexible terms and rates.[173]

1. *Venture Capital and Angel Investors*

Decreased business lending under Basel III will inevitably cause some SMEs to turn away from bank financing in search of alternative options.[174] These SMEs may turn to some of the more conventional sources of increased cash flow such as factoring,[175] purchase-order financing[176] and inventory-backed financing,[177] or may look to less traditional sources like crowdfunding.[178] However, the most feasible alternative source of funding will likely be capital investments in the form of venture capital or angel funding.[179]

For businesses, there may be some significant benefits and drawbacks to consider before turning to venture capital.[180] The most palpable advantage is that venture capital can provide the necessary financing to get a business up and running when the business is unable to secure credit through other means. Venture capitalists also tend to have deep pockets, with investments averaging between $500,000 and $5,000,000.[181] Another benefit is that venture capitalists generally have good business connections, which may help to provide contacts and guidance for a new business, as

---

172 Samaad, *supra* note 60.
173 *Id.*
174 *See* discussion *supra* Part III.C.2.
175 Factoring involves the sale of accounts receivable to a financial intermediary (a factor), at a discount, in exchange for cash.
176 With purchase-order financing, the financier guarantees the buyer's order and pays for the product to be manufactured. When the company receives payment from the buyer, the financier takes its cut and the company gets the rest of the proceeds.
177 Inventory-backed financing allows a company to obtain loans or credit by offering its inventory as collateral to protect against a default in payment.
178 Crowdfunding involves the use of small amounts of capital from a large pool of investors to finance a new business venture.
179 Mike Michalowicz, *Small Business Funding Options: Venture Capital vs. Angel Funding*, TOILET PAPER ENTREPRENEUR (May 5, 2012), http://www.toiletpaperentrepreneur.com/money-equity/small-business-funding-options-venture-capital-vs-angel-funding/.
180 *Id.*
181 *Id.*

well as another possible source of investors.[182] Other aspects of venture capital investment are less favorable for businesses. Venture capitalists have high expectations for returns from the companies they invest in and often require 50% or more of future profits.[183] With equity stakes this high, control of the company may effectively shift from the hands of the original business owner to the investor.[184] Furthermore, venture capitalists like to take their time before committing their money and often take at least six months before reaching a decision.[185]

Like venture capitalists, angel investors may provide a source of capital for startup businesses that are unable to secure sufficient funding through loans or other means.[186] Angel investors will generally contribute $250,000 to $500,000 to an early stage company and sometimes pool funds together with other angels to invest even larger amounts, possibly in the millions.[187] In exchange for these contributions, angel investors take an equity stake in the company, usually from 20% to 60%, depending on the amount of the initial contribution.[188] Not only do angels offer startups a source of much needed capital, but they are also able to provide guidance and support to the businesses they fund, as many angels are current or former entrepreneurs.[189] The downside is that finding an angel investor is a highly competitive process, with only around a 5% success rate among those companies seeking funding.[190] Furthermore, angel investing is only a feasible solution for a very limited category of businesses—certain startups who can demonstrate the kind of profit potential necessary to make the investment worthwhile—generally, this entails the ability to eventually go public or sell the company.[191]

2. *Non-Bank Financial Institutions*

a. *Business Development Corporations*

Business Development Corporations (BDCs) may provide another viable source of funding for businesses that are considered too high-risk to

---

[182] *Id.*
[183] *Id.*
[184] *Id.*
[185] Michalowicz, *supra* note 179.
[186] Sarah E. Needleman, *'Angels' Can Fund Your Next Step*, WALL ST. J. (Aug. 25, 2012), http://online.wsj.com.
[187] *Id.*
[188] *Id.*
[189] *Id.*
[190] *Id.*
[191] *Id.*

receive a traditional bank loan under the new Basel III standards.[192] BDCs are publicly traded investment companies that provide funding to businesses in the private sector.[193] Although BDCs' cost of capital is higher than a traditional bank loan, they offer an advantage in terms of their greater willingness to finance small businesses and startup companies and greater flexibility when it comes to negotiating payments with companies that are struggling to meet their financial obligations.[194]

b. *Shadow Banking Sector*

Some evidence indicates that since the adoption of Basel III, the shadow banking sector has grown larger than before the financial crisis.[195] This may be due, in part, to the fact that Basel III does not affect non-bank financial institutions. As non-bank financial institutions are not required to comply with the capital holding requirements, there is a possibility that shadow banking firms will see an opportunity in the market and begin extending greater amounts of credit to SMEs and startup companies.[196] Specifically, shadow banks such as hedge funds, unregulated investment funds and other limited-purpose finance companies can use investor funds to engage in direct lending to small business, free from the stringent standards to which banking institutions will be subject.[197] The ability of the shadow banking sector to engage in this sort of lending is problematic because Basel III's capital standards cannot effectively create economic stability if the financial system as a whole is overleveraged.[198]

---

[192] Vincent Ryan, *When Banks Won't Touch Your Company*, CFO.COM (Oct. 10, 2012), http://www3.cfo.com/article/2012/10/credit_nonbank-capital-alternative-financing-risk-appetite-prudential-solar-basel-iii?currpage=1.
[193] *Id.*
[194] *Id.*
[195] Sheng, *supra* note 115.
[196] OSHANI PERERA, INT'L INST. FOR SUSTAINABLE DEV., BASEL III: TO WHAT EXTENT WILL IT PROMOTE SUSTAINABLE DEVELOPMENT? 10 (June 2012) ("Acting as 'shadow banks,' these entities [e.g., hedge funds, insurance companies, buy-out funds] are free to use their investors' money and seek wholesale funding to engage in direct lending and other banking services without being subject to Basel III rules on capital and liquidity. Shadow banks are also reportedly targeting smaller businesses that 'are too large to visit their local bank but too small to attract the attention of the bond market.'" (internal citation omitted)).
[197] *Id.*
[198] Sheng, *supra* note 115.

IV. WHAT THE FUTURE HOLDS UNDER BASEL III

U.S. financial regulators have encountered an immense pushback from financial industry groups[199] that have protested that the new Basel III standards will seriously "hinder credit availability, dampen economic growth and harm the competitiveness of the U.S. banking system."[200] Notable among the groups protesting the new regulations are the American Bankers Association, Goldman Sachs and ICBA.[201] It seems that financial regulators have been persuaded by these concerns; although Basel III calls for implementation of the capital requirements to begin in January 2013, there has been indication on the part of financial regulators that they will delay implementing many of the standards beyond the 2013 date.[202] Furthermore, while U.S. regulators have placed pressure on the nineteen largest U.S. banks to show that they are making efforts to comply with Basel III, a firm date for compliance has yet to be established.[203]

Recent amendments to the Basel III liquidity requirements further suggest that regulators are responsive to banks' difficulties in meeting the new regulations.[204] Seeking to avoid another credit crunch that would cause banks to cut back on lending, regulators gave banks an additional four years to comply with the LCR requirement[205] and amended other provisions of the liquidity regulations.[206] Commentators viewed these concessions as a major victory for the banking industry and took it as a sign that there will be flexibility in the implementation of other regulatory measures.[207] The position that members of the BCBS has taken suggests a willingness to allow for this more flexible approach to implementation.[208] In spite of the failure of the United Kingdom and United States to comply with the

---

[199] Emily Stephenson, *Delay Seen in Implementing U.S. Bank Capital Rules*, FOX BUS. (Nov. 9, 2012), http://www.foxbusiness.com/news/2012/11/09/delay-seen-in-implementing-us-bank-capital-rules/.

[200] Jesse Hamilton & Cheyenne Hopkins, *Banks Say Regulators Should Rewrite Basel III Capital Rules*, BLOOMBERG (Oct. 23, 2012), http://www.bloomberg.com/news/2012-10-23/u-s-banks-say-regulators-should-rewrite-basel-iii-capital-rules.html (quoting a letter received during the public comment process).

[201] *Id.*

[202] Stephenson, *supra* note 199.

[203] Brooke Masters & Alex Barker, *US Banks Warned on Global Reforms*, FIN. TIMES (Nov. 30, 2012), http://www.ft.com/intl/cms/s/0/fdc11e20-3b1a-11e2-b111-00144feabdc0.html#axzz2Okb9iBgm.

[204] Brunsden, Broom & Moshinsky, *supra* note 42.

[205] *Id.*

[206] *On the Revisions to Basel III's Liquidity Requirements*, ECON. OF CONTEMPT BLOG (Jan. 23, 2013, 11:20 AM), http://economicsofcontempt.blogspot.in/2013/01/on-revisions-to-basel-iiis-liquidity.html.

[207] Brunsden, Broom & Moshinsky, *supra* note 42.

[208] Moshinsky, *supra* note 144.

January go-date for many of the regulations, Ingves has said that these delays are not critical at this point and has been receptive to concerns that the original regulations were too complex.[209] Other regulators have indicated that an acceptable timeframe for U.S. implementation of the new standards would be within the next two years.[210] Regulators' willingness to accept these delays suggest that the protests from the banking sector have not fallen upon deaf ears.

The receptiveness of U.S. regulators to concerns from community banks suggests the United States is also likely to adopt a more flexible approach regarding small bank regulation.[211] After receiving over 1500 letters on behalf of community bankers, the U.S. Senate Committee on Banking has realized that there is a need to "tailor the requirements as appropriate" to fit the needs of community banks.[212] Specifically, there has been some discussion that small banks should not be subject to the same risk-weight models that will be used by their larger counterparts.[213] However, while there seems to be general agreement that minor exemptions for community banks are permissible, many regulators are adamant that the crux of the regulations should still apply.[214] Although it seems doubtful that regulators would approve less stringent risk-weight models for community banks, it could have beneficial effects for small local businesses that rely heavily on financing from these banks.[215] These small local businesses would be considered high-risk under the conventional Basel III risk-weight system.[216]

Although Basel III may cause some SMEs to turn to alternative sources of financing such as venture capital,[217] it is likely that most small businesses will continue to rely predominantly on loans from banking institutions. In a tough economy, individual investors, even more than financial institutions, will likely think twice before shelling out their cash to high-risk SMEs and startups. Like venture capitalists and angel investors, other alternative

---

[209] *Id.*

[210] Stephen Fidler, Laurence Norman & Victoria McGrane, *EU Regulator: OK for U.S. to Delay Basel Rules*, WALL ST. J. (Jan. 25, 2013), http://online.wsj.com/article/SB10001424127887323539804578264274096324476.html (quoting Michel Barnier, the EU's Commissioner in charge of financial-market regulation).

[211] Cheyenne Hopkins & Jesse Hamilton, *Regulators Grilled at Hearing on Small Banks' Basel Burden*, BLOOMBERG (Nov. 14, 2012), http://www.bloomberg.com/news/2012-11-14/community-banks-basel-iii-burden-to-be-hearing-s-focus.html.

[212] *Id.*

[213] Stephenson, *supra* note 199.

[214] Danielle Douglas, *Small Banks Battle Regulators on Capital Requirements*, WASH. POST (Nov. 13, 2012), http://articles.washingtonpost.com/2012-11-13/business/35503987_1_community-banks-smaller-banks-basel-rules#.

[215] ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 9, at 39.

[216] *See* discussion *supra* Part III.B.

[217] Michalowicz, *supra* note 179.

lenders tend to be similarly risk-averse, leaving banks as the only viable financing option, aside from the shadow banking sector. While shadow banks are known for their willingness to take on high-risk investments, most SMEs and startups cannot offer the high returns necessary to entice shadow banks to invest. Furthermore, even with the possibility of less stringent requirements for community banks,[218] larger banks will be in a better position to extend financing to SMEs[219] due to their heightened ability to engage in regulatory arbitrage and greater capital holdings.

Ultimately, the disproportionate impact of the regulations will result in less competition between banks in the SME lending market, with large banks dominating a greater percentage of the market in SME lending and smaller banks being pushed to the sidelines.[220] According to data from the Federal Reserve Bank of Dallas, before the financial crisis, the largest 100 banks in the United States had an 84% market share, but by the third quarter of 2012, the top eighty-two U.S. banks held 88% of the market.[221] Rather than moving away from a "too-big-to-fail" system, these numbers show that just the opposite is occurring.[222] In January 2013, the twenty-five largest U.S. banks witnessed the greatest number of withdrawals on consumer deposits since the attacks on September 11, 2011—$114 billion (approximately 2% of total deposits).[223] This fact suggests that large banks will continue to rely heavily on credit and lending practices, rather than deposits, as a major source of revenue. Add the high capital costs imposed by Basel III into the mix[224] and it seems certain that large banks will take over a greater share of the SME lending market. In addition to the extra charges associated with the increased capital requirements,[225] decreased competition will cause further rate surges in SME lending.

Although Basel III has generated a large amount of criticism from politicians, financial regulators and prominent members of the banking industry, the trend will be toward more stringent capital requirements for banks.[226] What is less certain is the time frame and methods by which the

---

[218] Hopkins & Hamilton, *supra* note 211.
[219] Baldwin, *supra* note 91.
[220] *Id.*
[221] *Should Too-Big-to-Fail Banks Be Carved Up?*, INVESTOPEDIA ANALYST BLOG (Jan. 25, 2013), http://www.investopedia.com/stock-analysis/zacks/shouldtoo-big-to-failbanksbecarvedup-analystblog.aspx#axzz2J0w5xCUG.
[222] *Id.*
[223] Nick Summers, *Withdrawn: $114 Billion From Big U.S. Banks*, BUSINESSWEEK (Jan. 23, 2013), http://www.businessweek.com/articles/2013-01-23/missing-114-billion-from-u-dot-s-dot-banks.
[224] *See* King & Tarbert, *supra* note 7.
[225] SANTOS & ELLIOTT, *supra* note 86, at 4.
[226] Hoenig, *supra* note 126; Hopkins & Hamilton, *supra* note 211.

reforms will ultimately be implemented.[227] U.S. financial regulators' desire to ease the transitional burdens and refusal to impose strict dates for meeting the requirements suggests that banks will have a certain amount of flexibility in complying with the new guidelines.[228] Greater flexibility in implementing the Basel III rules may have the added benefit of easing some of the negative economic consequences. While stricter capital requirements will, at least to some extent, lead to a decrease in SME lending from U.S. banks,[229] careful and gradual implementation of the reforms may lessen some of the adverse impacts.

It is doubtful that Basel III will either prove to be the calamity prophesied by its harshest critics[230] or the "magic wand" solution touted by its proponents.[231] The moderated effect of Basel III may be largely attributed to bank lobbying efforts, which have resulted in revision to many of the more drastic provisions of the original regulations, including the LCR.[232] The new standards may result in tangible benefits in terms of greater long-term stability in the banking sector; these benefits would be particularly significant during times of economic stress.[233] However, large banks will likely capitalize on the opportunities for regulatory arbitrage left open by the regulations, which will undermine this stability to some extent.[234] Furthermore, the creation of stability in the banking sector will not come without some substantial costs.[235] Many small banks may fold under the additional pressure of Basel III or may no longer be able to continue SME lending practices.[236] This will leave larger banks with the lion's share of the SME credit market. The impact of all of this on small businesses will be higher costs and reduced credit availability,[237] which will push some businesses out of the market.

---

[227] Stephenson, *supra* note 199.
[228] Hopkins & Hamilton, *supra* note 211.
[229] INST. OF INT'L FIN., *supra* note 76, at 36.
[230] Hamilton & Hopkins, *supra* note 200.
[231] *See International Regulatory Framework for Banks (Basel III)*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/basel3.htm (last visited Mar. 30, 2013).
[232] Brunsden, Broom & Moshinsky, *supra* note 42.
[233] SANTOS & ELLIOTT, *supra* note 86, at 4.
[234] *See* discussion *supra* Part III.D.1.
[235] *See* INST. OF INT'L FIN., *supra* note 76, at 38.
[236] Donna Borak, *Community Banks: Basel III Will Put Us Out of Business*, AM. BANKER (Oct. 22, 2012), http://www.americanbanker.com/issues/177_204/community-banks-say-basel-iii-will-put-them-out-of-business-1053731-1.html.
[237] INST. OF INT'L FIN., *supra* note 76, at 38.